OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan
County Executive

Bruce Romer
Chief Administrative Officer

February 26, 2003

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended December 31, 2002. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of Section 33-51(a)(4) of the Montgomery County Code of 1994, as amended.

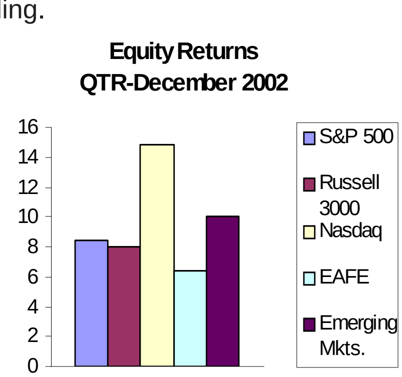
History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were 5,989 active members and 4,115 retirees participating in the System as of June 30, 2002.

Capital Markets and Economic Conditions

U.S. manufacturing increased in December by the largest gain in 11 years as new orders and production accelerated. The Institute for Supply Management's Factory Index rose more than expected to 54.7 in December from 49.2 the previous month (economists had expected a reading of 50, the breakeven point between contraction and expansion). That is the first reading greater than 50, signaling growth, since August and the highest since June. The 5.5-point increase was the largest since June 1991. With inventories lean, demand may be strong enough to boost orders and production. General Motors expects to build more vehicles this quarter than in the same three months of 2001. On January 8, the Federal Reserve reported consumer credit fell by $2.2 billion in November. That represents the first time since January 1998 that credit had declined. Consumers should be convinced to maintain moderate spending growth. The refinance/resale housing boom resulting from the low interest rate environment is a very important prop under consumer spending.

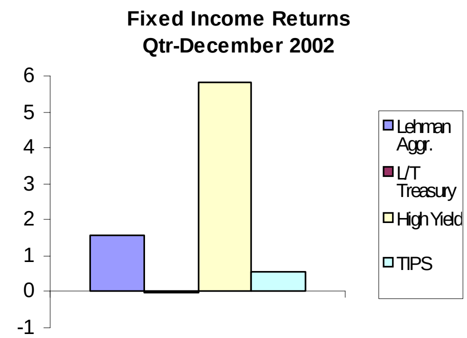
The U.S. equity markets had a very good quarter: the S&P 500, the Dow Jones Industrial Average, and the Nasdaq composite rose 8%, 10% and 14%, respectively (see chart to right). Small company stocks lagged, with the Russell 2000 Index of small capitalization stocks reporting a 6% increase. The information technology sector had the strongest gains, followed by the telecommunications and material sectors. Weak results were reported on consumer discretionary stocks and utilities where federal investigations continue.



However, large gains from stocks in October and November were given back in December primarily due to a decline in durable goods orders, weaker consumer spending and a rise in unemployement. Geopolitical events also contributed to the negative environment for equities: the escalating standoff with North Korea over its nuclear program, the threat of war with Iraq, and a nationwide strike in Venezuela that helped push oil above $30 per barrel. For the fourth quarter, our combined domestic equity performance was a gain of 6.54% compared to the 8.02% benchmark return. Our combined international equity performance was 8.33%, outperforming our benchmark index by nearly 150 basis points.

The Federal Reserve eased rates by 50 basis points on November 6. The Fed Chairman remarked that the latest rate cut should help the economy through its "soft patch" and if the recovery unfolds as expected, no further monetary stimulus would be needed.

Bonds had positive results, with strong gains coming from corporate bonds and weak returns from Treasuries. Within the investment grade corporate sector, credit spreads narrowed. High-yield bonds gained 5.83% (see chart on right) during the quarter bouncing back after a difficult few quarters. Returns for mortgage-backed securities fell but strong demand from banks and foreign investors offset the negative impact of refinancing. Our total fixed income performance was a gain of 3.11%, slightly ahead of our benchmark index.



Globally, European equity markets' fourth quarter rebound capped off an otherwise depressing year for equity investors. Corporate bonds provided strong returns, particularly the low-rated credits. The U.S. dollar depreciated more than 6% for the quarter against the Euro. Markets in the Pacific region lagged Europe and the U.S. markets in the fourth quarter but had better returns (still negative) relative to Europe and the U.S. for the year.

For the quarter ending December, the return for the total fund was a gain of 5.27% compared to the 6.11% of the System's benchmark. For the one-year period ended December 31, our return was a loss of 8.35% compared to the benchmark loss of 10.29%.

Additions

The primary sources of additions for the System include member and County contributions and investment income. The following tables show the source and amount of additions for the quarter ending December 31, 2002.

Employees' Retirement System
Contributions and Investment Income
(millions)

	Qtr Ended 12/31/02	Fiscal YTD
Employer Contributions	$ 14.0	$ 27.4
Member Contributions	3.8	7.5
Net Investment Income (Loss)	78.0	(81.4)
	$ 95.8	$ (46.5)

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, administrative expenses and other costs.

Employees' Retirement System Deductions by Type (millions)	**QTR ended 12/31/02**	**Fiscal YTD**
Benefits	$ 24.2	$ 48.2
Refunds	0.2	0.4
Administrative Expenses	0.6	1.0
	$ 25.0	$ 49.6

Outlook

The U.S. economy is rebounding after experiencing a sharp downshift in the early part of the fourth quarter. Drags from the atuo sector and the summer turbulence in financial markets are now fading. GDP is expected to rise to a 3% growth rate in the first quarter of 2003, close to its average over the past year. Firms are still reluctant to spend or hire as they struggle to restore profitability. However, the corporate healing process is moving forward. In the past year, profits and cash flow have increased, inventories have been drawn down, and debt levels have stabilized. In 2003, firms are expected to deliver a more balanced and firmly grounded recovery as the cautious stance of the business sector fades. The equity market rally should continue as earnings recover and geopolitical problems surrounding a war ease.

Major Initiatives

In the past quarter, the Board adopted an active approach to TIPS investing and began negotiations with an active TIPS manager. The Board amended its Manager Funding Policy shifting 10% of the domestic equity allocation from passive management to active management in the large cap growth sector and began a search for a large cap growth manager. The Board's website went live in December providing information to participants, County agencies, and the public related to the Board's oversight of the System's investments. In addition, the Board approved the fiscal year 2003 estimated and fiscal year 2004 preliminary budgets for the System.

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS
December 31, 2002

Assets	
Equity in County's pooled cash and investments	$249,553
Investments	
Northern Trust	1,793,300,442
Aetna	8,047,506
Fidelity - Elected Officials Plan	537,024
Fidelity - Deferred Retirement Option Plan	3,460,199
Total investments	1,805,345,171
Contributions receivable	3,285,896
Fixed assets, at cost:	
Office equipment	111,375
Less: accumulated depreciation	111,375
Net fixed assets	-
Total assets	1,808,880,620
Liabilities	
Benefits payable and other liabilities	227,439,975
Net assets held in trust for pension benefits	**$1,581,440,645**

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
December 31, 2002

Additions	***Quarter***	***Fiscal YTD***
Contributions		
Employer	$13,955,688	$27,401,020
Members	3,836,576	7,547,038
Total contributions	17,792,264	34,948,058
Investment Income (loss)	79,161,978	(78,858,807)
Less investment expenses	1,162,272	2,572,445
Net investment income	77,999,706	(81,431,252)
Total additions	95,791,970	(46,483,194)
Deductions		
Retiree benefits	18,323,628	36,580,015
Disability benefits	4,645,000	9,210,000
Survivor benefits	1,207,000	2,364,000
Refunds	190,932	389,534
Administrative expenses	586,829	1,052,730
Total deductions	24,953,389	49,596,279
Net increase (decrease)	70,838,581	(96,079,473)
Net assets held in trust for pension benefits		
Beginning of period	1,510,602,064	1,677,520,118
End of period	**$1,581,440,645**	**$1,581,440,645**